STANDARD
&POOR'S
Maalot

December 02, 2009

Standard & Poor's Maalot
12 Abba Hillel Silver St.
Ramat-Gan, 52506
Tel:972-3-7539700
Fax:972-37539710
www.maalot.co.il

Pardes Hanna Karkur Water Resources Ltd.

Primary Credit Analyst:
Sophia Grach, Tel-Aviv (972) 3-753-9724; sophia_grach@standardandpoors.com

Secondary Credit Analyst:
Shaul Ben Shimol, Tel Aviv (972) 3-753-9718; shaul_ben_shimol@standardandpoors.com

Table Of Contents

Pardes Hanna Karkur Water Resources Ltd.

Major Rating Factors

Credit Rating
iIB/Watch Negative

Strengths

- Local monopoly for water services for the Pardes Hanna Karkur local authority, providing vital services, the demand for which is stable.
- Part of the Housing & Construction Group, Israel's largest infrastructure group, which has (conditionally) guaranteed the company's commitments to its bondholders.

Weaknesses

- Exposure to possible cancellation of concession at the end of the current arbitration process.
- Low current collection rates and high water leakage rates, relative to stronger local authorities, due to local residents' below average socioeconomic status.
- Volatility of income from development levies.
- Externally set tariff structure that does not necessarily reflect input price rises.
- Relatively high investments required by the concession agreement.

Rationale

The rating on Israel-based water utility Pardes Hanna Karkur Water Resources Ltd. (PHK Water Resources) mainly reflects the risk to the company's continued position as the local water utility monopoly for the Pardes Hanna Karkur local authority up to August 2019, based on an agreement with the local authority-owned water and sewerage company, Pardes Hanna Karkur Fluid Infrastructure Company (FIC). Other constraints faced by the company include the below-average socioeconomic level of the local population (cluster 6 out of 10, according to a Central Bureau of Statistics survey from November 2009, based on 2006 data), which factor into the relatively low collection rates and high water leakage rates than in stronger local authorities; the volatility of income from development levies; and an externally set tariff structure which does not necessarily cover input price rises.

Following claims from both parties to the concession agreement of the other's breach of contract, the FIC is seeking to cancel the concession agreement and the dispute has now been placed in arbitration. Losing the concession would rob the company of content as it has no other fields of activity. In the event the concession agreement is brought to an end and certain covenants are triggered, then the bond trustee is expected to call for the bonds' immediate repayment. Though an interim decision has allowed for the concession to continue for a further five years, i.e. up to August 2014, the arbitrator's final decision on the dispute may cancel the concession before this date.

Ultimate parent company Housing & Construction has guaranteed in favor of the bondholders up to NIS8.85 million (not linked to the CPI). This guarantee is not automatically extended to the end of the bond period, but is renewed annually for as long as the company's liquidity ratio doesn't meet that set at the time of the bond issue. While the guarantee from the ultimate parent company is a supporting factor for the rating, the conditionality of the guarantee prevents us from equalizing the rating of PHK Water Resources with that of Housing & Construction.

Key business and profitability developments

Most of the company's income—about 81% in 2008 and 75% in the first half of 2009—is from water and sewage charges, which are stable and highly visible. Despite a fall in per-capita consumption as a result of a national campaign to save water, including usage caps and fines, income is still expected to increase in the coming years due to the construction of new neighborhoods. However this visibility is compromised due to the uncertainty regarding the outcome of the arbitration process and due to the uncertainty regarding expected changes in water and sewage tariffs and relevancy of these changes to the company. The rest of the company's income is from development levies, which are volatile, being dependent on the pace of local development.

Current collection rates—86% in the first half of 2009 compared with 79% in 2008—and water leakage rates—about 10% in the first half of 2009 compared with 14.2% (about 12% after adjustments) in 2008—are weaker than leading water and sewage companies. This, together with external factors such as rising fees from Mekorot, the National Water Company, and rising production taxes, reduce the company's profit margins. The company's operating profitability is on a downward trend, and stood at 20% in the first half of 2009, compared with 21%, 23% and 26% in the preceding three years, respectively. We expect this trend to continue in the second half of 2009 and in 2010.

Key cash flow and capital-structure developments

The company's capital structure continues to improve following the payment of its existing commitments and a rise in its equity. Debt to CAP was 56% as of June 2009, compared with 59% as of December 2008 and 65% at end-2007. However we place a greater stress on debt cover ratios when they are relatively low. While funds from operations (FFO) to debt improved in the first half of 2009 to 23.8% (compared with 12.6% in 2008 and 11.4% in 2007), this rise was mostly a result of income from development levies and therefore we do not consider this improvement as permanent.

Liquidity

In recent years the company has posted a positive cash flow from its current activities and finances its investment requirements from its development levies and its own capital. However this continued cash flow is in doubt in light of the risk of a cancellation of the concession agreement.

As of June 30, 2009 the company had a bank deposit pledged in favor of the bondholders of NIS5.6 million which serves as the debt service fund and the OPEX (operating expenses) fund.

CreditWatch

We will monitor developments concerning the arbitration process. Should the arbitrator decide in favor of FIC then this could lead to a further downgrade of the rating. However should the decision be in the company's favor, we could raise the rating.

Business Description

PHK Water Resources holds the concession for managing and operating the water resources of the Pardes Hanna Karkur (PHK) local authority. Under the concession, the company is responsible for the supply of water, sewerage and drainage services for the PHK population, and for maintenance and development of the water, sewerage and drainage infrastructures. The company is fully owned by Housing & Construction (ilA-/Negative) through a corporate chain that includes Housing & Construction Environment (formerly Blue Green Development and Investments).

The 20-year concession to August 2019, which was won through a tender run by Pardes Hanna Karkur Fluid Infrastructure Company (FIC), gives PHK Water Resources the status of a local monopoly. The concession is renewed automatically every five years, on condition that the company has not breached any of its commitments.

In November 2007 FIC filed for the cancellation of the concession in August 2009, i.e. at the end of its then current 5-year period, due to alleged breach of contract, which was met by a similar counterclaim from the company, mainly that FIC had not updated the sewage charges. Little progress has been made in the arbitration process since then, apart from an interim decision, that allows the concession to continue for a further five years, i.e. up to August 2014, though the concession may be halted at any time subject to the arbitrator's final decision.

Rating Methodology

Our evaluation of the effect that the guarantee from Housing & Construction has on PHK Water Resources' rating is based on the S&P research paper "*Utility ratings criteria for guarantees and support agreements*" (published January 13, 1999 and available on www.standardandpoors.com). S&P applies strict standards when reviewing guarantees to ensure that the obligation of the guarantor is unconditional and enforceable. However Housing & Construction's guarantee is conditional and this prevents us from assigning to PHK Water Resources the same rating as the guarantor.

Business Risk Profile: Uncertain Future As Local Monopoly

The major constraints for PHK Water Resources' weak business risk profile are:

- The risk to the company's position as a local monopoly in the PHK local authority. A dispute over continuance of the company's concession is in arbitration, and the loss of the concession would rob the company of content, as it has no other fields of activity.

- Regulatory risk. The government is considering extending the application of the Water and Sewerage Corporations Law (2001) on the water and sewerage systems in Pardes Hanna Karkur, which started to operate in its current status before this legislation was enacted. If applied, this would include reforms in household tariffs, and the development levies would be abolished which currently contribute to the company's source of cash flow.
- External setting of tariffs. Currently the price of water for the end-user is set by the Water Authority, while sewage fees and development levies are set by the local authority. These prices do not protect the company from increased input prices or rising costs of sewage treatment, which has led to an erosion of operating profit margins in recent years.
- Relatively weak operating parameters. Low socioeconomic features (cluster 6 out of 10, as of November 2009) factor in the relatively low current collection rates and high water leakage rates than in stronger authorities. Total collection rates have risen to reasonable levels only after concerted efforts by the company that required additional operating expenditure.

These constraints are mitigated by:

- The low risk of Israel's water industry. The sector is characterized by limited competition and high barriers to entry. Services supplied by the company are essential goods. For as long as the company has the concession, the company is a local monopoly for the supply of water and sewerage services for the local authority.
- For the most part, stable and predictable income. Company income derives from the size of the population, the make-up of local residents and pace of development. Most income comes from water and sewage charges, which are highly visible.
- Higher profit margins than most of its peers. Despite the challenging conditions of operation and erosion of profit margins, the company continues to post stronger operating profits than its peer group, due to its operating efficiency and savings in general and administrative expenses.
- Increase in population due to new neighborhoods and potential for continued development. The development of the area is a source of current income in the form of development levies and increase in future profits in respect of water and sewage fees. Also the development of future neighborhoods, intended for stable, higher socioeconomic classes (such as IDF officers), provides an opportunity to improve PHK's socioeconomic standing and as a result, will lead to an improvement in the company's operating results.

Financial Risk Profile: Low Coverage Ratios

The major weaknesses of PHK Water Resources' financial risk profile are:

- Lower coverage ratios than similarly S&P- and S&P Maalot-rated peers, as seen in the FFO to debt and cover ratio of interest expenses by EBIT and EBITDA. In our opinion the improvement in these ratios that began in the first half of 2009 was temporary and stemmed from the relatively high income from development levies.

- Risk of loss of intangible assets in the event of the concession's cancellation. The concession fees paid by the company in 1998 and expenses for development of the water system are registered as intangible assets and are depreciated to the end of the concession period in August 2019. The balance of intangible assets on the company's books as of June 30, 2009 was NIS20.6 million. According to the terms of the agreement, in the event of concession cancellation due to the company's breach, the company is not entitled to a refund of the concession fees or compensation for its investments. The results of any process for compensation due to general contract laws are unpredictable.

These weaknesses are mitigated by:

- Generation of positive cash flow. In recent years the company has generated positive cash flow, mostly of a permanent nature, from its current activities. It finances its investments from current cash flow (which includes development levies) and does not need additional financial debt.

- Limits to drawing downstream shareholder loans, management fees or dividends. Most of Housing & Construction Environment's investment in the company is through shareholder loans subordinate to all other commitments, to be paid only after the bonds. The company has an equity deficit, but due to the subordination of the related party loans we have adjusted the company's equity by adding these loans to the balance sheet equity.

- A deposit of NIS5.6 million (as of June 30, 2009) pledged in favor of the bondholders, which serves as both as the debt service fund and the OPEX fund.

Financial Statistics / Adjustments

The company reports according to the Israel reporting standards and not according to IFRS, as it is not currently obliged to do so, being a private company.

We make the following adjustments:

1. Adding the shareholders loans to the balance sheet equity given that these are subordinate to other financial obligations, and which will be paid only after payment of bonds.
2. The addition of income/expenses in respect of the revaluation of long-term obligations to changes in working capital. This adjusts the FFO to create a base comparable to companies with non-linked liabilities.
3. The company's interest expenses include the revaluation of long-term obligations.

Table 1

Reconciliation Of Pardes Hanna Karkur Water Resources Ltd Reported Amounts With S&P Maalot's Adjusted Amounts (Mil. NIS)

	--Fiscal year ended Dec. 31, 2008--		
Pardes Hanna Karkur Water Resources Ltd reported amounts			
	Shareholders' equity	**Operating income (after D&A)**	**Cash flow from operations**
Reported	(8.5)	4.8	3.5
Standard & Poor's adjustments			
Equity-like hybrids	20.7		
Reclassification of nonoperating income (expenses)		(0.7)	--
Reclassification of working-capital cash flow changes		--	1.8
Other		--	(3.2)
Total adjustments	20.7	(0.7)	(1.4)
Standard & Poor's adjusted amounts			
	Equity	**EBIT**	**Funds from operations**
Adjusted	12.2	4.1	2.0

Table 2

Pardes Hanna Karkur Water Resources Ltd Peer Comparison*

	Pardes Hanna Karkur Water Resources Ltd	Mekorot Water Company Ltd	Gelsenwasser AG¶§	Acquedotto Pugliese SpA¶§	Northumbrian Water Ltd.¶§
Rating as of Nov. 2, 2009	ilB/Watch Negative	ilAAA/Stable	BBB+/Stable/--	BB+/Stable/B-1	BBB+/Stable/--
Country	Israel	Israel	Germany	Italy	Italy
	--Fiscal year ended Dec. 31, 2008--				--Fiscal year ended March 31, 2009--
(Mil. $)					
Revenues	6.0	1,031.7	763.2	539.1	994.9
EBITDA	1.8	211.3	152.8	69.4	539.2
Operating income (before D&A)	1.8	211.3	153.8	74.7	538.3
Operating income (after D&A)	1.3	102.2	100.1	38.5	393.6
Net income from continuing operations	0.0	46.2	139.8	0.1	(18.2)
Funds from operations (FFO)	0.5	187.4	159.0	30.0	310.7
Capital expenditures	0.7	205.0	42.6	182.2	316.2
Cash and short-term investments	0.2	106.3	20.9	0.0	0.0
Debt	4.7	1,284.3	210.4	343.8	3,359.3
Equity	3.2	683.9	1,287.8	207.1	368.9
Debt and equity	8.0	1,968.2	1,498.2	550.9	3,728.2
Adjusted ratios					
EBITDA/revenues (%)	30.1	20.5	20.0	12.9	54.2
Operating income (before D&A)/revenues (%)	30.1	20.5	20.1	13.8	54.1
EBIT interest coverage (x)	1.0	2.0	12.4	1.8	2.0
EBITDA interest coverage (x)	1.7	3.4	13.4	1.9	2.6
Return on capital (%)	14.3	5.7	9.5	11.8	8.9
FFO/debt (%)	11.4	14.6	75.6	8.7	9.2
Debt/EBITDA (x)	2.6	6.1	1.4	5.0	6.2
Total debt/debt plus equity (%)	59.3	65.3	14.0	62.4	90.1

*Fully adjusted. ¶Fully adjusted (including postretirement obligations). §Excess cash and investments netted against debt.

Table 3

Pardes Hanna Karkur Water Resources Ltd Financial Summary*

	--Fiscal year ended Dec. 31--			
	2008	**2007**	**2006**	**2005**
Rating history	ilBBB/Watch Negative	ilA+/Watch Negative	ilA+/Stable	ilA+/Stable
(Mil. NIS)				
Revenues	22.7	19.6	19.6	16.6
Operating income (before D&A)	6.8	6.5	6.8	3.3
Operating income (after D&A)	4.8	4.6	5.2	1.8
Net income from continuing operations	0.1	1.3	2.4	(1.5)
Funds from operations (FFO)	2.0	3.1	3.8	(0.1)
Capital expenditures	2.7	2.3	1.1	0.6
Cash and short-term investments	0.9	1.1	1.3	1.7
Debt	17.8	18.1	19.6	20.2
Preferred stock	0.0	0.0	0.0	0.0
Equity	12.2	9.7	6.6	3.0
Debt and equity	30.0	27.9	26.2	23.2
Adjusted ratios				
EBIT interest coverage (x)	1.0	1.4	2.1	0.5
EBITDA interest coverage (x)	1.7	2.0	3.1	1.0
FFO interest coverage (x)	0.5	1.0	1.7	(0.0)
FFO/debt (%)	11.4	16.9	19.5	(0.3)
Discretionary cash flow/debt (%)	4.1	8.6	(2.0)	9.0
Net Cash Flow / Capex (%)	73.9	132.8	340.8	(8.4)
Debt/debt and equity (%)	59.3	65.1	74.9	87.0
Return on common equity (%)	1.0	16.5	49.4	(49.9)
Common dividend payout ratio (un-adj.) (%)	0.0	0.0	0.0	0.0
*Fully adjusted. N.M. - Not Meaningful.				

Ratings Details (As of November 2009)	
Credit Rating (Series A)	**ilB/Watch Negative**
Ratings History	
13-July-2009	ilB/Watch Neg
13-Jan-2009	ilBBB/Watch Neg
24-Dec-2007	ilA+/Watch Neg
March 2003	ilA+
Feb-2000	ilAA-

Debt Maturities

As Of December. 31, 2008:

2010:	NIS962 thousand
2011:	NIS962 thousand
2012:	NIS962 thousand
2013:	NIS962 thousand
2014:	NIS962 thousand